Nos. 15,011 to 15,015

United States
COURT OF APPEALS
for the Ninth Circuit

UNITED STATES OF AMERICA, Appellant,
v.
MONTE L. WOLF, Executor of the Estate of Harry J. Wolf, deceased, Appellee.

UNITED STATES OF AMERICA, Appellant,
v.
MONTE L. WOLF, Transferee of the Estate of Jennie Wolf, deceased, Appellee.

UNITED STATES OF AMERICA, Appellant,
v.
BLOSSOM M. GRAYSON, Transferee of the Estate of Jennie Wolf, deceased, Appellee.

UNITED STATES OF AMERICA, Appellant,
v.
CHARLOTTE C. COHON, Transferee of the Estate of Jennie Wolf, deceased, Appellee.

UNITED STATES OF AMERICA, Appellant,
v.
MANUEL SCHNITZER, HAROLD SCHNITZER and LEONARD SCHNITZER, Executors of the Estate of Sam Schnitzer, deceased, Appellees.

On Appeal from the Judgments of the United States District Court for the District of Oregon.

BRIEF OF APPELLEES

S. J. BISCHOFF,
Cascade Building,
Portland 4, Oregon,
JACOB, JONES & BROWN,
Public Service Building,
Portland 4, Oregon,
Attorneys for Appellees.

STEVENS-NESS LAW PUB. CO., PORTLAND, ORE. 7-56

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STATEMENT

References to the Transcript of Record will, in all cases, refer to the Transcript in Docket No.

15011. The Transcripts of Record in the other cases are, in all respects, material to this appeal, the same as in Docket No. 15011.

The actions were brought to recover refund of taxes erroneously collected (admitted) from the taxpayers.

The five cases were consolidated for the purpose of trial in the Court below because the questions involved are the same.

The cases were tried and submitted to the Court below upon an agreed statement of facts set forth in the Pre-trial Order entered in each case and the exhibits referred to therein under the heading of "Agreed Facts" (Tr. of Rec. 41 to 53). The Pre-trial Orders are, in all of the cases, the same with respect to all of the facts relevant to these appeals.

The stipulated facts, admit that Appellees overpaid the taxes for the year in question (Tr. of Rec. 48 to 52); that the plaintiffs are entitled to judgments for the amounts set forth in the Pre-trial Order unless recovery is barred by **Section 322(c) of the Internal Revenue Code** or by the principles of res judicata and collateral estoppel (Tr. of Rec. 51).

It is also stipulated that the overpayments for which the plaintiffs are entitled to a judgment, unless barred as aforesaid, are as follows:

Action Number	As Per Plaintiffs' Computation	As Per Defendant's Computation
7097	$41,608.89	$24,955.82
7098	13,025.09	8,162.57
7099	13,025.09	8,162.57
7100	13,025.09	8,162.57
7102	41,719.77	25,143.06

with interest as required by law (Tr. of Rec. 51).

Judgments were rendered in the Court below for the plaintiffs-appellees in accordance with plaintiffs' computation.

The pertinent facts, so far as material to the questions presented on these appeals as they are set forth in the Agreed Facts in the Pre-trial Order, are as follows:

In 1943, the tax year in question, and for many years prior thereto, Alaska Junk Co. was a partnership composed of four partners. They were:

Sam Schnitzer, Rose Schnitzer,
Harry J. Wolf, Jennie Wolf.

Each had a one-fourth interest in the partnership.

In 1941 the partners, and another, named Morris Schnitzer, who had no interest in the partnership, organized a corporation to construct a steel mill and engage in the manufacture and sale of steel. Each of the partners subscribed for capital stock of the corporation.

The partnership advanced monies and sold merchandise to the corporation during the period of

time that the mill was under construction in the tax year in question.

The **cash** advances made by the partnership to the corporation were carried on the books of the partnership as loans to the corporation.

The **merchandise** supplied by the partnership to the corporation was treated by the partnership as "sales" to the corporation and were carried on the books of the partnership as "accounts receivable."

The partnership kept its books and made its income tax returns on the calendar year **accrual** basis. Accordingly, the partnership **included the "sales" to the corporation in the "gross income"** in the tax year in question **in making the partnership income tax information return** and were included in the distributive share of each of the four partners in determining each partner's share of the partnership net income. **Each of the partners paid income taxes thereon.**

In November 1943, the partners were forced to abandon the venture and dispose of their stock interests in the corporation. The obligations from the corporation to the partnership for the advances and the sales of merchandise became worthless in 1943.

In making the income tax returns for the year 1943, the partners took, as a deduction, the losses sustained by the partners **by reason of the worthlessness of the obligations** from the corporation to

the partnership, **including the loss from the sale of merchandise as aforesaid.**

The Commissioner of Internal Revenue disallowed the loss deductions on the ground that the loans made and the merchandise sold to the corporation **constituted capital contributions** to the corporation and were not "sales" deductible as bad debt losses. He, accordingly, determined a deficiency for the tax year 1943 based upon the disallowance of the deductions.

In determining the deficiency, as aforesaid, **the Commissioner did not reduce the "gross income" so as to eliminate therefrom the "sales"** which he determined to be capital contributions.

All of the partners involved in these cases filed petitions with the Tax Court of the United States to review the said determination of the Commissioner. The Tax Court sustained the Commissioner's determination insofar as it disallowed the bad debt loss deductions. On appeal this Court affirmed the decision of the Tax Court and certiorari was denied by the Supreme Court.

Thereafter, the deficiencies were assessed against and were collected from all of the taxpayers and all of the taxpayers paid the deficiencies.

The result of the determinations and the payment of the deficiencies, was, that in each case, the **amount of taxes paid on the return as filed, plus the deficiency determined as aforesaid, exceeded,**

in each case, the total tax liability of each taxpayer for the year in question to the extent shown above. This is conceded by the stipulated facts (Tr. of Rec. 48-52). This concession was made because it was recognized by defendant that since it was determined that the merchandise delivered by the partnership to the corporation did not constitute sales, the partnership erroneously included the sales in the reported gross income and the partners erroneous paid income tax thereon.

Plaintifs then filed claims for refund of the taxes erroneous collected. The claims were rejected and these actions were brought to recover refund of the excess taxes.

The defendant contended that the plaintiffs are barred from recovering the admitted overpayments by reason of the prosecution of the proceedings in The Tax Court of the United States and in the alternative, if they are not barred by Section 322(c) of the Revenue Code, they are barred by the principles of res judicata or collateral estoppel by judgment, both being based on the judgments rendered by the Tax Court.

The Court below held that plaintiffs were not barred by **Section 322(c) of the Internal Revenue Code** from suing to recover the refund of the overpayments; that they came within the purview of Exception No. 2 to Section 322(c); that they were not barred by the principles of res judicata and collateral estoppel and rendered judgments in favor of the plaintiffs-appellees.

A question was presented as to the proper basis for computing the amount of the refund in each case. Appellees contended, and made their computations, by deducting from the "gross income" shown in the original returns, the amount of the "sales" determined to be capital contributions.

Defendant-appellant contended, and made computation, by deducting, on the one hand, the "sales" from the gross income and, on the oher hand, the cost of the "sales" (the goods delivered to Oregon Steel), from the total cost of "sales" shown in the return.

The Court below adopted the computations made in accordance with plaintiff's contention on the theory that it was not proper to deduct the cost of "sales" in arriving at the net income for the year in question.

The pertinent "Agreed Facts" recited (Tr. of Rec. 48):

> "As a result of said adjudication, it follows that the '**sales**' to Oregon Electric Steel Rolling Mills were **erroneously** carried on the books of the Alaska Junk Company as accounts receivable; they were **erroneously included in the gross income** of the partnership for 1942 and 1943; the **income and victory taxes** paid by the partners . . . . . on their distributive shares therefrom under the original returns, **were erroneously paid**; and the amounts of such **'sales' should have been excluded from the gross income of Alaska Junk Company,** thus reducing the amount of the net income reportable by (each partner) on his individual income and victory tax return for the taxable year 1943.
>
> . . . . .

(Tr. of Rec. 51):

> "The parties stipulate that the above computations are true and correct and that in the event the Court shall determine that the prosecution of this action is not barred by Section 322(c) of the Internal Revenue Code of 1939, or by the principle of res adjudicata, and/or the doctrine of collateral estoppel, **the judgment to be entered in favor of the plaintiff, shall be in accordance with and for the amount of overpayment shown in whichever of the above computations is determined by the Court to be applicable under the circumstances, to-wit:"**

Following this paragraph, in each case, is the amount to be allowed in accordance with the computation of the plaintiffs or the defendant whichever was to be adopted by the Court.

I

THE ACTIONS ARE NOT BARRED BY SECTION 322(c), INTERNAL REVENUE CODE OF 1939. THE CASES COME WITHIN THE EXCEPTION NO 2 TO SECTION 322(c).

Section 322 of the Internal Revenue Code is a comprehensive statute dealing with many phases of claims for refunds of taxes illegally collected.

Subsection (a)(1) provides:

> "(a) **Authorization**
>
> "(1) **Overpayment.** Where there has been an overpayment of any tax imposed by this

chapter, the amount of such overpayment shall be credited against any income, war-profits, or excess-profits tax or installment thereof then due from the taxpayer, and any balance shall be refunded immediately to the taxpayer."

Subsection (b)(1) is a statute of limitations applicable to claims for refund.

Subsection (b)(2) deals with limits on the amount of credit or refund.

Subsection (b)(3) deals with exceptions in the case of waivers.

Subsection (c) provides:

"(c) Effect of petition to Board. If the Commissioner has mailed to the taxpayer a notice of deficiency under section 272(a) and if the taxpayer files a petition with the Board of Tax Appeals within the time prescribed in such subsection, no credit or refund in respect of the tax for the taxable year in respect of which the Commissioner has determined the deficiency shall be allowed or made and no suit by the taxpayer for the recovery of any part of such tax shall be instituted in any court except—

"(1) As to overpayments determined by a decision of the Board which has become final; and

"(2) As to any amount **collected** in **excess** of an amount computed in accordance with the decision of the Board **which has become final;**

"(3) As to any amount collected after the period of limitation upon the beginning of distraint or a proceeding in court for collection has expired; but in any such claim for credit

or refund or in any such suit for refund the decision of the Board which has become final, as to whether such period has expired before the notice of deficiency was mailed, shall be conclusive."

Subsection (d) provides:

"(a) **Overpayment found by Board.** If the Board finds that there is no deficiency and further finds that the taxpayer has made an overpayment of tax in respect to the taxable year in respect of which the Commissioner determined the deficiency, or finds that there is a deficiency but that the taxpayer has made an overpayment of tax in respect of such taxable year, the **Board shall have jurisdiction to determine the amount of such overpayment,** and such amount shall, when the decision of the Board has become final, be credited or refunded to the taxpayer. No such credit or refund shall be made of any portion of the tax **unless** the **Board determines as part of its decision** (1) **that such portion was paid** . . . . ."

The Commissioner of Internal Revenue made a determination that the "sales" made to Oregon Steel were not "sales," but were "capital contributions" and upon that theory, disallowed the loss deductions taken by the plaintiffs resulting from the worthlessness of the account receivable.

Appellees filed petitions with the Tax Court for review of the Commissioner's determination. In such proceeding, plaintiffs contended that the sales, carried on partnership's books as "sales" and as "accounts receivable," were "sales," in law and in fact, and that they were entitled to the deductions when the accounts receivable became worthless.

The only issue (aside from the issue of partnership not now material) in that proceeding, was whether the transactions referred to were "sales" or "capital contributions."

The Tax Court affirmed the determination of the Commissioner. The decision of the Tax Court was affirmed by this Court and certiorari was denied by the Supreme Court. That detemination resulted in the assessment of deficiencies against the plaintiffs by reason of the disallowance of the loss deductions.

When the decision of the Tax Court became final, the deficiencies were collected. The agreed facts establish that the taxes, originally paid when the returns were filled, plus the amounts collected in accordance with the determination of the deficiencies, resulted in an overpayment of the tax liability of each of the plaintiffs for the year in question.

The transactions between the partnership and Oregon Steel involved in the Tax Court proceeding, could not, of course, be at the same time "capital contributions" and "sales."

The final judgment of the Tax Court, affirmed on appeal, established that the "sales" on which taxes were paid, were erroneously included in the gross income for the year in question and it follows that the taxes paid thereon were erroneously collected.

As long as the taxpayers believed and contended that the deliveries of merchandise constituted "sales," they could not of course, and did not, in those proceedings, claim any refund of the taxes paid on those sales as a part of the gross income of the partnership.

The right to claim a refund of the taxes paid on those sales as a part of the gross income of the partnership, arose for the first time **after** the Tax Court affirmed the determination of the Commission **and the taxpayers paid, and the Collector collected from the taxpayers, the deficiencies** resulting from the determination that the merchandise constituted capital contribution. It was the in invitum reversal of the transaction by the judgment of The Tax Court from "sales" to "capital contributions" and the assessment of the deficiencies resulting therefrom **and the collection** of these deficiencies **after** The Tax Court's final determination, that **gave rise for the first time** to the right of a refund of the income taxes paid on the sales.

The "excess" collection **came into being and accrued** only when the deficiency was paid **after** the decision "which has become final." It was the collection of the "deficiency" plus the amount originally paid, that resulted in the "excess" collection. **There were no overpayments at any time until after the Tax Court determination became final and the deficiencies were paid.**

These cases come within the purview of Exception Number 2 to Section 322(c) of the Internal Revenue Code which preserved to the taxpayer the right to seek refund of taxes "**collected in excess** of an amount computed in accordance with the decision of the Board **which has become final.**"

This exception relates to amounts "collected" after the determination of The Tax Court, when the **collection results in creating an** "excess" of the amount of tax liability legally due. In other words, if The Tax Court makes a final determination requiring a computation which produces an excess of tax liability and that excess is collected **after** the judgment has become final, the exception Number 2 preserves the right to recover that excess.

Prior to the judgment of The Tax Court, and the collection of the deficiency, there was no payment in excess of the legal tax liability for the tax year. Prior to the decision, only a portion of the true tax liability as determined had been paid, to-wit, the payment made when the original return was filed in which the bad debt deduction was taken. The balance of the tax for that year was paid after The Tax Court's decision became final. It is only by adding the tax payments originally made to the tax paid on the determination of the deficiencies, that the **admitted** "excess" was "collected" and this, of course, was after the decision of The Tax Court became final.

The taxpayers could not have asserted any

claim of "overpayment" or for refund in The Tax Court because that claim did not accrue until the payment was made pursuant to the judgment determining the deficiency which was after The Tax Court's decision became final. There was no "overpayment" at any time while the case was pending in The Tax Court.

In **United States v. Jaffray, 97 F. 2d 488,** (8th Cir.), the Court held:

> "The cause of action **accrued at the time the overpayment was made** to the Collector. Guettel v. United States, 8 Cir., 95 F. 2d 229."

The Taxpayers could not have asserted any claim for refund in The Tax Court because that Court had **no jurisdiction** to determine or order a refund of taxes unlawfully collected.

The jurisdiction of The Tax Court is limited.

Section 322(d) of the Internal Revenue Code provides:

> "(d) Overpayment Found by Board.—If the Board finds that there is no deficiency and further finds that the taxpayer has made an overpayment of tax in respect of the taxable year in respect of which the Commissioner determined the deficiency, the Board shall have **jurisdiction** to **determine,** the amount of such **overpayment,** and such amount shall, when the decision of the Board has become final, be credited or refunded to the taxpayer."

The statute is implemented by the REGULATIONS 111, Section 29.322-7 as follows:

> "(1) If the Tax Court finds that there is **no deficiency** but that the person has **overpaid**

> his tax for the year to which the notice of deficiency relates, and the decision of The Tax Court as to the amount overpaid has become final (see section 1140, set forth in paragraph 39 of the Appendix to these regulations), the **overpayment** shall be credited or refunded, but no such credit or refund shall be made of any portion of the tax **unless The Tax Court determines** as part of its decision—
>
> (i) that such portion **was paid**—"

It is obvious that the jurisdiction of The Tax Court is limited to determination of an "overpayment" that **has already been made and paid.** The Tax Court is required to make a finding that an overpayment has been made.

The Tax Court had no **jurisdiction** to determine **prospectively** that an overpayment **will result** as and when a deficiency determined by it will be collected from the taxpayer.

There is nothing in the provisions of Section 322(c) to indicate that it was the intention of Congress to penalize a taxpayer who was compelled to pay a deficiency determined by the judgment of The Tax Court when the amount so collected added to the amount paid upon the filing of the return results in an overpayment (excess) of the tax liability.

The **cause of action was created by the decision of The Tax Court** which reversed the transaction and determined that the "sales" were not "sales" and the cause of action accrued when the deficiency was collected "after the decision became final."

Subdivision (c) of Section 322 is in the nature of a statutory application of the rules of res judicata to Tax Court proceedings. It was obviously designed that all issues that could arise **under the conditions existing at the time the proceeding is pending** with respect to a particular tax year, should be raised and determined in the one proceeding.

It is also obvious, however, that the framers of **subsection (c)** were aware that injustices could arise from an arbitrary bar which would preclude all relief with respect to the problem involving a particular tax year, which would be inconsistent with the remedial character of the legislation embodied in **Section 322(a)**. The Congress, in that subdivision of the Act, obviously intended to insure that taxes in excess of the correct tax liability, should not be collected and if collected, should be refunded "immediately."

The Congress was undoubtedly also aware that an **excess collection** could be made under varying circumstances **after the decision of The Tax Court has become final.**

The Congress, therefore, attached three specific exceptions to the bar created by **subdivision (c)**, all of which preserves a right to seek refund after the decision of The Tax Court has become final, which precludes a construction of **subdivision (c)** that would bar absolutely and under all conditions the right to seek a refund after the decision of The

Tax Court has become final when the claim for refund involves the same tax year.

Exception No. 2 deals specifically with a situation such as exists in the case at bar. Indeed, if it does not govern the case at bar, it can serve no conceivable purpose and it would be a nullity.

Exception No. 2 should be construed as did the Court in the case of **Schmitt v. Kavanagh, 91 F. Supp. 659.** The Court held:

> "In attempting to construe the applicable statutes, it may be helpful to keep in mind that the **defendant admits that there has been an overpayment** but asserts that the plaintiff has no remedy, notwithstanding the obvious attempt of Congress to make provision for refunds to taxpayers who have overpaid their taxes. **Such an interpretation of the Code ought to be avoided unless it is clear that Congress intended to exclude such relief.**" (Emphasis supplied.)

In **Bull v. United States, 295 U.S. 247, 55 S. Ct. 695,** the Commissioner of Internal Revenue treated a fund both corpus of the decedent's estate for the purpose of fixing the estate tax and also as income to the executor subject to income tax, thus imposing double taxation. The Court held that this was inconsistent and in discussing the relief to be afforded to the taxpayer, the Supreme Court of the United States recognized the purpose of the remedial legislation embodied in what is now the whole of Section 322 of the Internal Revenue Code. The Court said:

> "In recognition of the fact that erroneous determinations and assessments will inevitably occur, the statutes, in a spirit of fairness, invariably afford the taxpayer an opportunity at some stage to have mistakes rectified . . . .
>
> . . . . .
>
> The United States, we have held, cannot, as against the claim of an innocent party, hold his money which has gone into its treasury by means of the fraud of their agent. United States v. State Bank, 96 U.S. 30, 24 L. Ed. 647. While here the money was taken through mistake without any element of fraud, **the unjust detention is immoral and amounts in law to a fraud on the taxpayer's rights."** (Emphasis supplied.)

The situation is, of course, the same in principle in the case at bar for here, too, the transactions under consideration could not be sales subject to income tax and capital contributions, which would deprive the taxpayer of the right to a loss deduction upon the failure to receive payment. The plaintiffs have been concededly subjected to double taxation: first, by payment of income tax on the sales and, second, by an increase of the amount of its tax through the denial of the loss deduction, and the principles recognized by the Supreme Court in the Bull case are applicable to the case at bar.

Appellant's argument in the brief, in effect, ignores the exceptions to **subdivision (c)**, and particularly exception No. 2 thereof. It *ignores* the remedial character of **Section 322(a)** and the obvious scheme of the entire **Section 322** with all its exceptions to preserve under varying conditions the

right to recover refund of taxes illegally collected even though the tax liability for a given year was involved in The Tax Court proceeding and especially so **where the excess tax collected was the direct result of the decision which has become final and payment of the excess was exacted and collected after the decision has become final.**

The theory that the tax year is a unit under **Section 322(c)** is modified by the exceptions included therein. The adoption of the theory of the appellant that the tax year is a unit for all purposes and that the bare prosecution of a proceeding in The Tax Court involving a given tax year, is an absolute bar under all conditions, would render the exceptions nugatory.

In the case at bar, the claims for refund were not and could not be presented or litigated or determined in the Tax Court proceeding. There was no overpayment or excess tax collection in existence at any time while the Tax Court proceeding was pending.

While the Tax Court had jurisdiction to determine the existence of an overpayment, it could not do so in the case at bar because there was no overpayment in fact at that time. The collection of the excess was made after the decision of the Tax Court became final and the amount of the deficiency determined thereby was collected.

In **Commissioner v. Gooch Milling & Elevator Co., 320 U.S. 418, 64 S. Ct. 184,** the Court held:

> "The Board is confined to a determination of the amount of deficiency **or overpayment** for the particular tax year as to which the Commissioner determines a deficiency and as to which the taxpayer seeks a review of the deficiency assessment. Internal Revenue Code, §§ 272, 322(d), 26 U.S.C.A. Int. Rev. Code, §§ 272, 322(d). **It has no power to order a refund or credit** should it find that there has been an overpayment in the year in question. United States ex rel Girard Trust Co. v. Helvering, 301 U.S. 540, 54, 57 S. Ct. 855, 856, 81 L. Ed. 1272."

The use of the word "collected" in Exception No. 2 to Section 322(c) is highly significant. The Exception preserves the right to recover a refund which was "collected" and not a refund of an amount "determined."

The **computation** to be made, that is **referred to in the exception,** is one that must be made **after the "decision" "which has become final."** It does not refer to the computation under Rule 50 which is made **before** the **decision becomes final.** It refers to the computation that gives effect to the decision upon which the collections were made **and the amounts thus collected.**

In **Moir v. United States, 149 F. 2d 455** (First Circuit), the Court quoted and reviewed legislative history of **Section 322(c),** and the exceptions, and italicized the portion of the Senate Report reading as follows:

> " '**It is the purpose of the bill that all questions arising prior to the time the decision of**

> **the Board has been rendered as to the right of the Commissioner to assess and collect the tax, including the question as to whether or not the statute of limitations has run before the mailing of the deficiency letter, shall be determined by the Board, and by the courts on appeal from the Board.' "**

With respect to the purpose of the Act as set forth in this portion of the Report, the Court said:

> "When the committee goes on to say that it is the purpose of the bill 'that all questions **arising prior to the time the decision of the Board** has been rendered as to the right of the Commissioner to assess and collect the tax * * * shall be determined by the Board,' it apparently has **reference to the express exceptions** in the section, some of which do relate to events taking place after the decision of the Board has been rendered; for instance, where a deficiency found by the Tax Court has been wrongfully collected after the expiration of the statutory period of limitations upon the beginning of distraint, or where the Commissioner has wrongfully collected an amount in excess of that computed in accordance with the decision of the Tax Court." (Emphasis supplied.)

This confirms appellees' contention that **Section 322(c)**, with its exceptions, creates a bar only as to "all questions **arising prior to the time the decision of the Board has been rendered** . . . . ," and that the statute does not operate to bar a cause of action which accrues subsequent to the time the decision of the Tax Court becomes final by the collection of an excess tax.

Re Authorities Cited by Appellant.

Numerous cases are cited in support of the proposition that the filing of a petition with the Tax Court forecloses any other proceeding involving the tax year in question. But none of the cases involve the **application of the exceptions** embodied in the statute.

The **second** exception reserves the right to sue for refund of any amount "collected" in "excess" of an amount computed in accordance with the decision of the Tax Court "which has become final." It relates to an amount **collected after** the judgment has become final if it is in excess of an amount determined "in accordance with the decision of the Board."

The **third** exception relates to an amount collected **after** the Board's determination of a deficiency has become final and collection of the tax so determined is made after the expiration of the period of limitation for distraint.

The **first** exception deals with collections made prior to the final judgment and the **second** and **third** exceptions deal with collections made **after** final judgment.

It is admitted that the amount collected after the judgment became final in this case, when computed in accordance with the "decision," is in excess of the lawful tax liability. The decision and the collection produced this result. The collection of the excess accrued the liability.

The three exceptions to the bar, when read in the light of the whole of Section 322 of the Internal Revenue Act, are, in legal effect, a modification of or limitation upon the bar created by the doctrine of res judicata generally and as it is incorporated in the forepart of subdivision (c) to avoid the injustice and hardship of unlawful tax collection.

The case of **Bankers' Reserve Life Co. v. United States 44 F. 2d 1000,** cited by appellant, is not relevant. The taxes involved in that case were paid **before** the institution of the Tax Court proceeding. They were paid at the time the income tax returns were filed. The Court held that these alleged overpayments could have been asserted in the Tax Court proceeding because the Tax Court had jurisdiction to determine an "overpayment." The case did not involve the application of any of the exceptions to Section 322(c). The case was not determined on the doctrine of res judicata.

In stating the substance of what is now Section 322(c), the Court was careful to point out that "exceptions" were "not here present."

The case of **Cook v. United States, 108 F. 2d 804,** is not relevant. It did not involve the application of **exception No. 2 to Section 322(c) of the Internal Revenue Code.** The right to sue for refund was not predicated upon any of the exceptions.

The Court, after quoting **Section 322(c),** said:

" '(the exceptions are not applicable here).' "

In that case, the Commissioner determined a deficiency. The taxpayer petitioned the Tax Court for review and paid the deficiency determined by the Tax Court. Taxpayer thereafter sued to recover the same amount instead of appealing from the decision. In that case, it was **not admitted that the payment of the deficiency resulted in an overpayment** of the taxes due by the taxpayer for the year in question.

In the case at bar, **it is admitted that the payment resulting from the disallowance of the loss deduction, plus the payment originally paid, results in an overpayment** of the taxes and this is due to the fact that the taxpayer treated the merchandise delivered to Oregon Steel as "Sales" and paid taxes thereon. It was the subsequent determination that these were not sales that gives rise to this claim for refund of the taxes paid thereon.

The case of **Fiorentino v. United States, 226 F. 2d 619,** cited by appellant, is not relevant. In that case, too, the Court, after quoting **Section 322(c),** said:

> " 'Then follows certain exceptions not relevant here.' "

The action for refund was not predicated on the application of any of the exceptions. It was predicated on the contention that the Tax Court had dismissed the petition for review for want of prosecution; that such dismissal did not constitute a determination, and that by reason thereof, the Tax

Court had no jurisdiction. This was the only question involved and is foreign to the case at bar.

The case of **Staten Island Shipbuilding Co. v. United States, 31 F. Supp. 166,** cited by appellant, is not relevant. In that case, the overpayment, which was the subject of the action for refund, was made **prior** to the commencement of the Tax Court proceeding and the Court held that the taxpayer

> "had the right to show that it had overpaid its taxes"

in the Tax Court proceeding. The statute expressly confers jurisdiction upon the Tax Court to determine an overpayment which had actually been made. Moreover, the parties entered into a stipulation in the Tax Court upon which the final determination was made, determining the controversies involved, both as to the deficiency determined by the Commissioner and as to overpayment, and upon that stipulation, the Tax Court entered an order that there was "no deficiency" and "no overpayment due the taxpayer."

In the case at bar, there was no overpayment when the Tax Court proceedings were initiated or while they were pending, and there was no stipulation and judgment determining that there was no overpayment. The overpayment came into being for the first time after the decision of the Tax Court became final and payment was made of the additional taxes.

The case of **Bear Mill Mfg. Co., Inc. v. United States, 93 F. Supp. 988,** is not relevant. In that case, the claim for refund involved monies that were paid **prior** to the determination of a deficiency by the Commissioner. In fact, the deficiency was determined after the claim for refund was filed with the Commissioner and the Commissioner informed the taxpayer, in the 90 day deficiency letter that

> "the issue set forth in his claim for a refund should be made a part of the petition to be considered by the Tax Court in any redetermination of its tax liability."

The overpayment having been made prior to the commencement of the Tax Court proceeding, the Tax Court had jurisdiction to determine the issue of overpayment. Not so, in the case at bar, because there was no overpayment at any time during the pendency of the Tax Court proceeding.

The case of **Lehigh Valley Trust Co. v. United States, 34 F. Supp. 839,** cited by appellant, is not relevant. In that case, the Commissioner determined a deficiency at a time when the collection of additional tax was barred by the statute of limitations. Taxpayer petitioned for review, but did not, in the Tax Court proceeding, set up the statute of limitations as a bar. In that proceeding, a stipulation was entered into which fixed the partnership's tax liability and a final judgment, determining a deficiency in that amount, was entered. The taxpayer did not make any contention in the Tax Court that the claim for deficiency was barred.

The taxpayer paid the deficiency and asked for refund, claiming that the collection was barred. It predicated its right to prosecute the action for refund on the third exception to Section 322(c).

The third exception is as follows:

> " 'As to any amount collected after the statutory period of limitations upon the beginning of distraint or a proceeding in court for collection has expired; but in any such claim for credit or refund or in **any such suit for refund** the **decision** of the **Board** which **has become final,** as to whether such **period has expired** before the **notice of deficiency was mailed,** shall be **conclusive.'** "

The Court merely held that the taxpayer was bound to raise the defense of statute of limitations in the Tax Court proceeding and the decision of the Tax Court on the issue of the statute of limitations would be conclusive in any claim for refund. But not having raised the issue in the Tax Court, the judgment of the Tax Court precluded raising the issue by a subsequent action for refund. In arriving at its decision, the Court gave consideration to the Conference Report when read in connection with the Report of the Senate Committee on Finance. That Report said in part:

> "If the Board decided that the statute had run against a collection and the Commissioner proceeded to collect in spite of that decision, a suit could be maintained to recover the payment."

The Committee apparently intended that there would be a surviving right to prosecute an action

for refund under conditions similar to those in the case at bar for here, too, the final decision of the Tax Court resulted in the collection of taxes admitted to be in excess of the tax liability notwithstanding its determination that the items which the taxpayer treated as "sales" and paid taxes thereon, were not "sales" and consequently not subject to income tax payment.

The case of **Merrill v. United States, 152 F. 2d 74,** cited by appellant, is not relevant.

In that case, the taxpayer brought an action for refund of taxes based upon an Act of Congress allowing certain deductions, which Act became effective after the final determination of the Tax Court in which all questions pertaining to the taxpayer's tax liability were litigated and determined.

The question whether the taxpayer's claim comes within any of the exceptions to **Section 322(c)** was not involved.

Elbert v. Johnson, 69 F. Supp. 59, affirmed, **164 F. 2d 421,** cited by appellant, did not involve the application of Exception No. 2, or any of the exceptions, to Section 322(c). The Court of Appeals said (p. 423) that the **"exceptions (were) not presently applicable."** The Court pointed out:

> **"It is urged that in addition to the exceptions specified in the statute, the court should read in another,** namely, as to an overpayment in a prior year as to which the Tax Court lacks jurisdiction to allow credit against the deficiency for the taxable year in suit."

The case did not involve **excess payments** "collected" after the decision of the Tax Court had become final, but involved payments made **prior** to the Tax Court proceedings which could have been litigated therein and an adjudication of "overpayment" obtained.

Judge Learned, in his concurring opinion in that case, said:

> "That decision (Bull v. United States, 295 U.S. 247, 55 S. Ct. 695), as I understand it, **permits a taxpayer without penalty to assert his versions of a transaction, until it is finally decided against him.** That is to say, if the transaction is susceptible of two interpretations, and the taxpayer has paid a tax which was required by the interpretation he puts upon it, **he does not forfeit his right to a refund of that tax,** because the statute of limitation has run against him before the courts have finally decided that his interpretation was wrong; the statute is tolled." (Emphasis supplied).

That observation of Judge Hand dissipates the contention made in defendant's brief to the effect that plaintiffs should have anticipated an adverse decision on the question of the **loss deduction** and should have pleaded in accordance with such anticipation in the Tax Court. Under Judge Hand's observation, based upon the **Bull case,** the plaintiffs in this case had a right to stand on the contention that the merchandise delivered to the Corporation were "sales" and not "capital contributions" because they had so treated the transactions in good faith, and paid the income taxes on those sales.

They could maintain that position "without penalty" to their present assertion that they are entitled to a refund of those taxes after the Court determined that they were not sales, but capital contributions.

In this case, we do not seek to **"re-litigate"** any issue that was tried and decided in the Tax Court. On the contrary, this case is based upon the determination of the issues made by the Tax Court. That Court determined that the transactions, which the plaintiffs treated as sales and upon which they paid income taxes, were not sales at all; that they were capital contributions and for that reason, refused to allow the deduction of the losses sustained in those transactions. In the case at bar, **plaintiffs accept that determination.** It was that determination and the additional taxes "collected" by reason thereof that created the "excess" collected by the defendant.

The case of **Ross v. United States, 75 F. Supp. 725,** is irrelevant for the same reasons that are applicable to the **Merrill Case,** supra. It involved the identical question, to-wit, whether **Section 322(c)** was impliedly repealed by the 1942 Act which made provision for certain deductions.

II

RECOVERY IS NOT BARRED BY THE DOCTRINE OF RES JUDICATA OR COLLATERAL ESTOPPEL.

Defendant makes the alternative contention that **if plaintiffs are not barred** by Section 322(c) of the Internal Revenue Code, that they are barred by the application of the doctrine of res judicata or collateral estoppel.

It is not claimed, and cannot be, that the right to a refund was litigated and determined in the Tax Court proceedings.

It is only contended that the claim **could have been** presented in the Tax Court proceedings under Rule 50 of that Court.

A

Res Judicata and Collateral Estoppel Are Not Applicable to Cases that Come Within the Exceptions to Section 322(c).

If the Court determines that the actions were not barred by the provisions of **Section 322(c)** and the exceptions thereto, then the doctrine of res judicata and collateral estoppel cannot have any application to the case at bar because the doctrines, if applied, would be contrary to the provisions in the exceptions which were designed to preserve the

cause of action for refund notwithstanding the rendition of a final judgment in the Tax Court proceeding.

To apply the doctrines of res judicata and collateral estoppel, when the exceptions are applicable, would, in effect, be a judicial repeal of the exceptions to **322(c)**.

In **Crown Willamette Paper Co. v. McLaughlin, 81 F. 2d 365,** (Ninth Cir.) taxpayer sued for refund of taxes alleged to have been collected after collection was barred by the statute of limitations. Taxpayer had contested the validity of the assessments in the Tax Court and the determination of the Commissioner was affirmed. Actions for refund were brought after the final decision of the Tax Court. The Commissioner contended, as in the case at bar, that the decision of the Tax Court were res judicata. This Court held:

> "Appellee contends that they are res judicata, and that appellant and the courts are concluded thereby. This contention cannot prevail. It is based on section 322(c) of the Revenue Act of 1932, c. 209, 47 Stat. 242, 26 U.S.C.A. § 3322 (c), see 26 U.S.C.A. § 322 (c), which provides that, with certain exceptions, no suit shall be instituted by any taxpayer for the recovery of any tax in respect of which a petition for redetermination has been filed with the Board of Tax Appeals. One of the exceptions specified in section 322(c) is: 'As to any amount collected after the period of limitation upon the beginning of distraint or a proceeding in court for collection has expired.' This suit comes within that exception and is maintainable, not-

withstanding the proceedings before the Board of Tax Appeals.

"In making this exception, section 322 (c) provides that 'in any such suit for refund the decision of the Board which has become final, as to whether such period has expired before the notice of deficiency was mailed, shall be conclusive.' **This provision is inapplicable here, because, in this case, no such question was presented to or decided by the board.**"

Under this decision, the doctrine of res judicata is inapplicable in a case that comes within any of the exceptions to **Section 322(c)**. In that case, the third exception was involved. In the case at bar, the second exception is involved. But the principle is the same and it follows, that if this Court affirms the decision of the Court below, that the actions were not barred by **Section 322(c)** and that they come within the second exception, then the question of res judicata and collateral estoppel and the application to the case at bar becomes moot.

In **Merrill v. United States, 152 F. 2d 74,** cited by appellant, the Court of Appeals for the Second Circuit, recognized that the doctrine of res judicata has no application to a case coming within the purview of **Section 322(c)** and the exceptions thereto. In that case, the taxpayer made the same contention that is now made by appellant. The Court held:

"We see no merit in taxpayers' suggestion that res judicata doctrines must control the effect of the Board's decision, and that therefore § 322(c) is no bar as to any matter which could not have been raised before the Board.

> The issue here concerns a statute of limitations and not res judicata."

However, if the Court deems discussion of the doctrines relevant, we submit the following observations in respect thereto:

B

Re: Res Judicata

It is settled beyond question that where the second proceeding is "upon a different cause or demand," the principles of res judicata have no application. Only collateral estoppel could become involved.

> Commissioner of Internal Revenue v. Sunnen, 333 U.S. 591, 68 S. Ct. 715;
> Cromwell v. County of Sac, 94 U.S. 351;
> Mercoid Corporation v. Mid-Continent Investment Co., 320 U.S. 661, 64 S. Ct. 268;
> Larsen v. Northland Transportation Co., 292 U.S. 20, 54 S. Ct. 584.

In the cases cited above, it is established beyond question that the doctrine of res judicata (as distinguished from collateral estoppel) applies only where the parties and the "cause or demand" or the " subject matter" of the two proceedings are the same.

If the "causes of action" or the "subject matter" of both proceedings are not the same, then only the doctrine of collateral estoppel may become involved

with respect to a particular issue common to both proceedings **which has been actually litigated and adjudicated.**

The doctrine of collateral estoppel does not apply to cases in which issues **could and might have been presented and adjudicated, but where not presented or adjudicated,** and that is true whether the presentation of the issue in the earlier proceeding was permissive or compulsory.

In the case at bar, the "cause or demand" or the "subject matter" of the litigation, is not the same as in the prior Tax Court proceeding.

In the Tax Court proceeding, the "cause or demand" or "subject matter" was the allowance of "loss deduction" resulting from the worthlessness of accounts receivable and notes receivable. The case involved the relationship between the taxpayers and the Oregon Steel and whether the items, carried as accounts receivable and notes receivable, were, in fact and in law, "capital contributions."

In the present proceedings, there is no such issue. The action is to recover an **admitted** overpayment of the taxes and is predicated on the adoption of the determination made in the Tax Court as to the relationship of the parties.

It is the decision of the Tax Court and the collection of the excess taxes after the decision became final, that gave rise to the present cause of action.

Section 322(c) is, itself, in the nature of a statutory rule of res judicata, which is made subject to three specific exceptions.

In **Murphy v. United States, 78 F. Supp. 236** (U.S. D.C., S.D., Cal.), the Internal Revenue Agent, after examination of the estate tax return, informed the taxpayer that a deficiency would be determined. The taxpayer paid to the Commissioner the amount indicated by the Revenue Agent. Thereafter, a formal determination of a deficiency was made and a proceeding was brought in the Tax Court to review the determination. In the Tax Court the parties agreed upon the amount of the deficiency, which was less than the amount paid in, and a judgment of no deficiency was entered. Thereafter, the Collector remitted to the taxpayer the difference between the amount paid in and the amount determined by the stipulation. Taxpayer claimed that the estate was entitled to interest on the excess payment. He filed a claim therefor. The claim was rejected and an action was brought to recover the interest. Judge Mathes held:

> "The suit at bar is on a 'different cause or demand' from that in the Tax Court, since it does not involve the tax liability of the estate of Bernardine Murphy. Rather it is a suit for damages for the alleged retention of money due the plaintiff—interest. (Stewart v. Barnes, supra, 153 U.S. at page 464, 14 S. Ct. at page 852, 38 L. Ed. 781.) Moreover, **the matter in issue at bar**—whether or not there was an "overpayment in respect of any internal revenue tax' within the meaning of I.R.C. § 3771(a)—**was**

> **not actually litigated or decided in the Tax Court, though determination of that issue is within the jurisdiction of that court.** (I.R.C. § 912.) The judgment of the Tax Court, entered pursuant to stipulation of the parties, embodied nothing more than an adjudication 'that there is no deficiency.'
>
> "Thus the principle enunciated in the **Sunnen case, supra,** (333 U.S. 591, 68 S. Ct. 719) that 'Once a party has fought out a matter in litigation with another party, he cannot later renew that duel,' is not applicable here." (Emphasis supplied.)

It follows that the doctrine of res judicata (distinguished from collateral estoppel) is not applicable to the case at bar.

C

Re: Collateral Estoppel.

The doctrine of collateral estoppel is not applicable to the case at bar because the claims for refund, which are the "subject matter" of these actions, were not, and could not be, presented and litigated in the Tax Court proceeding for the obvious reason that the **causes of action were not even in existence.** The causes of action accrued after the decision of the Tax Court became final and the excess taxes were collected.

In **Martin v. Brodrick, 177 F. 2d 886,** (10th Cir.) (a tax refund case), the Court held:

> "Certainly a **claim is not barred until it comes into being and can be appropriately as-**

> **serted.** It has never been thought that a judgment barred a second action, based upon **new facts created by the first. The fact that both actions arise out of the same subject matter is immaterial.** Freeman on Judgments, 5th Ed., Sec. 712, p. 1501.
>
> . . . . .
>
> "We agree with the Fourth Circuit that the necessity for repose in litigation does not warrant the application of res judicata to **a claim which was not in being** when the first claim for refund was filed, and **the existence of which** was **contingent upon the disposition of that claim.** And especially where, as here, the **jurisdiction** to determine the amount of the claim **rested in another forum."** (Emphasis supplied.)

In the case s at bar, the claims for refund are

"based on new facts created by the first"

judgment in The Tax Court and the collection of the deficiency determined thereby. These created the "excess."

Here, too, the claim was not "in being" when the final judgments in The Tax Court were entered. The claims came **into being** when the collections were made.

The Tax Court had no jurisdiction to entertain any proceeding for the recovery of a **"refund"** or **to determine and order a refund** in the proceedings pending before that Court.

As heretofore pointed out, The Tax Court's jurisdiction was limited by statute to the determination of a "deficiency" or an "overpayment." It obviously had no power to determine an "overpay-

ment" in these cases for no "overpayment" had been made at any time prior to or during the pendency of the proceedings in The Tax Court. An overpayment resulted only from the payments that were made **after the decision of The Tax Court became final** and by reason of the determination of that Court.

It is settled beyond question that res judicata cannot be predicated upon decisions of a Court (even if made) when the Court has no jurisdiction of the subject matter.

In **Magruder v. Safe Deposit & Trust Co. of Baltimore, 159 F. 2d 913 (4th Cir.),** the action was brought to recover taxes wrongfully collected. The defendant asserted the doctrine of res judicata. The Court held:

> "In a leading work in this field, 2 Freemen on Judgments 5th Ed., 1925, § 712, at page 1501, it is stated:
>
> . . . . .
>
> "Id. § 669, p. 1479: 'It is, of course, obvious that **issues outside the jurisdiction of the court to determine, cannot become res adjudicata by virtue of its judgment.** But even where the matter is not jurisdictional, a judgment is not ordinarily deemed to be an estoppel as to issues which cannot properly be litigated in the proceedings in which it is rendered.'
>
> . . . . .
>
> "Every good doctrine or principle of law has sometimes been unduly stretched to encompass injustice. Res judicata is no exception. **The propriety of the deduction here claimed is admitted; there was certainly grave**

> **doubt as to just how the claim could be asserted.** We think, under all the circumstances of the instant case, that equity, good conscience and fair play justify Judge Coleman's view that res judicata should not serve as a bar to the present action which seeks a deduction of the attorneys' fees here (for the purpose of the federal estate tax) from the gross estate." (Emphasis supplied.)

In **Larsen v. Northland Transp. Co., 292 U.S. 20, 54 S. Ct. 584,** the Court held:

> "The established rule in this Court is that if in a second action between the same parties, **a claim or demand different from the one sued upon in the prior action** is presented, then the judgment in the former cause is an estoppel 'only as to those matters in issue or points controverted, upon the determination of which the finding or verdict was rendered.' (Citing cases.) 'While a defendant must bring forward all purely defensive matter, he is **not barred** by a former judgment against him **as to any matter which he was not bound to present and which was not in fact litigated. A judgment is not conclusive of those matters as to which a party had the option to but did not in fact put in litigation in the action.'** Freeman on Judgments (5th Ed.) § 786." (Matters in parenthesis and emphasis supplied.)

In **Commissioner of Internal Revenue v. Sunnen, 333 U.S. 591, 68 S. Ct. 715,** the Court held:

> "But where the second action between the same parties is upon a **different cause or demand,** the principle of **res judicata** is applied much more narrowly. In this situation, the judgment in the prior action operates as an estoppel, **not as to matters which might have**

been litigated and determined, but '**only** as to those matters in issue or **points controverted,** upon the determination of which the finding or verdict was rendered.' (Citing cases.) Since the cause of action involved in the second proceeding is not swallowed by the judgment in the prior suit, the parties are **free to litigate points which were not at issue** in the first proceeding, **even though** such points **might have been tendered and decided at that time.**

. . . . .

"**These same concepts are applicable in the federal income tax field.**

. . . . .

"Before a party can invoke the collateral estoppel doctrine in these circumstances, the legal matter raised in the second proceeding must involve the same set of events or documents and the same bundle of legal principles that contributed to the rendering of the first judgment." (Matters in parenthesis and emphasis supplied.)

In **Cromwell v. County of Sac, 94 U.S. 351,** the Court held:

"But where the second action between the same parties is upon a different claim or demand, the judgment in the prior action operates as an estoppel **only as to those matters in issue or points controverted, upon the determination of which the finding or verdict was rendered.** In all cases, therefore, where it is sought to apply the estoppel of a judgment rendered upon one cause of action to matters arising in a suit upon a different cause of the action, the **inquiry must always be as to the point or question actually litigated and determined** in the original action, **not what might have been thus litigated and determined.** Only

upon such matters is the judgment conclusive in another action.

. . . . .

"These cases, usually cited in support of the doctrine that the determination of a question directly involved in one action is conclusive as to that question in a second suit between the same parties upon a different cause of action, **negative** the **proposition that the estoppel can extend beyond the point actually litigated and determined.** The argument in these cases, that a particular point was **necessarily** involved in the finding in the original action, proceeded upon the theory that, if not thus involved, the judgment would be **inoperative** as an **estoppel."** (Emphasis supplied.)

In **Mercoid Corporation v. Mid-Continent Inv. Co., 320 U.S. 661, 64 S. Ct. 268,** the Court held:

"Though Mercoid were barred in the present case from asserting any **defense** which might have been interposed in the earlier litigation, it would not follow that its **counterclaim** for damages would likewise be barred. That claim for damages is more than a defense; it is a separate statutory cause of action. **The fact that it might have been asserted** as a counterclaim in the prior suit by reason of Rule 13(b) of the Rules of Civil Procedure, 28 U.S.C.A. following section 723c **does not mean that the failure to do so renders the prior judgment res judicata** as respects it. (Citing cases.) The case is then governed by the principle that where the second cause of action between the parties is upon a different claim the prior judgment is res judicata **not as to issues which might have been tendered** but 'only as to those matters in issue or points controverted, upon the determination of which the finding or verdict was rendered.'" (Matters in parenthesis and emphasis supplied.)

In **Pelham Hall Co. v. Hassett, 147 F. 2d 63 (1st Cir.)**, the Court held:

> "We believe, on the contrary, that particularly as regards questions of law in tax cases, **collateral estoppel** by judgment **should be rather narrowly applied.** To minimize the recurring hardship to the taxpayer or prejudice to the revenue (as the case may be), with respect to the taxes for all succeeding tax years, **neither the taxpayer nor the government should be precluded from raising a relevant point of law unless it appears beyond doubt that the precise point was actually contested and decided** (not merely assumed) in the prior litigation.
>
> . . . . .
>
> "When the taxpayer filed with the Board its petition for review, the indications then were that the transaction would not be held to be a taxfree reorganization." (Emphasis supplied.)

Under these decisions, the judgment in The Tax Court proceedings does not constitute res judicata or collateral estoppel by judgment.

D

Re: Effect of Rule 50 of The Tax Court of The United States.

On July 14, 1949, The Tax Court first rendered its "findings of fact and opinion" (pages 29 to 70 of the printed record, Joint Exhibit No. 1) in which it merely determined that "all of the advances were contributions to capital and that the resulting worthlessness of a part thereof was not a bad debt"

(page 70). It did not determine the amount of the deficiency, but provided that "decisions will be entered under Rule 50" (page 70).

The Tax Court did not make any determination that there was, or would be, an overpayment as the result of its determination.

Rule 50 of the Tax Court sets up the procedure for making of computation upon which the final judgment is to be entered. It provides:

> "If in accordance with this Rule computations are submitted by the parties which differ as to the amount to be entered as the decision of the Court, the parties will be afforded an opportunity to be heard in argument thereon on the date fixed, the Court will determine the correct deficiency or overpayment and enter its decision.
>
> **"Any argument under this Rule will be confined strictly to the consideration of the correct computation of the deficiency** or **over-payment resulting from the report already made, and no argument will be heard upon or consideration given to the issues or matters already disposed of by such report or of any new issues.** This Rule is not to be regarded as affording an opportunity for rehearing or reconsideration." (Emphasis supplied.)

The Commissioner filed a computation in each case based upon the determination that the claimed losses were not bad debts, but capital contributions and computed the deficiencies on that basis.

The partners (taxpayers) did not, and could not, object to the computation submitted by the

Commissioner because it was made in accordance with the decision of The Tax Court and The Tax Court entered its final judgment in each case based upon the computation as submitted by the Commissioner determining the amount of the deficiency in each case. Final judgment was entered thereon and thereafter the deficiencies were collected.

By adding in each case the amount of the deficiencies so determined and collected to the amount of tax paid by each taxpayer on the filing of his return, the total so collected exceeded the amount of the lawful tax liability of each taxpayer to the extent and in the amount agreed upon in the agreed statement of facts according to the computation which the Court might hold applicable.

Defendant contends that the taxpayers should have litigated their right to "refund" in The Tax Court by the proceedings provided for in Rule 50 of The Tax Court. Plaintiffs contend that the issue now before the Court could not have been litigated in the proceeding; that The Tax Court had no jurisdiction to entertain any proceeding for a "refund" and would not have been entertained by The Tax Court if the issue had been tendered it.

Rule 50 only permits the submission of computations to aid the Court in determining the **amount** of the deficiency or the **amount** of "overpayment." The rule was not promulgated or designed to permit the tendering of issues as to the

existence of deficiency or overpayment. Those issues were determined by the findings and opinion. All that the Rule contemplated was **mathematical computation** and not the disposition of questions of fact or law affecting the respective rights of the parties.

The Tax Court could not, under Rule 50, go beyond the scope of determining the amount of de--ficiency. It could not determine overpayment when **the Court did not, in its findings and opinion, determine that there had been an overpayment.** It could not order a refund under the guise of computation.

The Tax Court took extreme precautions to guard against the use of the procedure for computation under Rule 50 as a vehicle for introducing issues of fact or of law, for in the concluding paragraph of the Rule, it provided:

> "Any argument under this Rule will be **confined strictly to** the consideration of the **correct computation** of the deficiency or overpayment resulting from the report already made, and no argument will be heard upon or consideration given to the **issues or matters already disposed of** by such report or of any new issues. This Rule is not to be regarded as affording an opportunity for rehearing or reconsideration." (Emphasis supplied.)

If the taxpayers had attempted to obtain an adjudication of "overpayment" or "refund" in the proceedings under Rule 50 by objecting to the Commissioner's computation and submission of its own computations, it would have been **necessary to ten-**

der new issues of fact and of law for determination by The Tax Court.

The taxpayers could not have tendered these issues in their **original petition** to The Tax Court. In order to do so, the taxpayers would have been compelled to admit that the advances were all capital contributions. They could not make such an admission because they believed, in good faith, (although ultimately held to be in error) that they were not capital contributions and that the merchandise delivered were bona fide sales upon which they were compelled by law to pay income tax, since they were on the accrual basis. They were not bound to assume that The Tax Court would decide the issue against them.

Rule 50 has been construed by the Court to preclude the introduction of new issues.

In **Bankers' Pocahontas Coal Co. v. Burnet, Commissioner, 287 U.S. 308, 53 S. Ct. 150,** the Court held:

> "Third. After the Board of Tax Appeals had filed its findings of fact and opinion, both respondent and petitioner submitted recomputations of the amount of the deficiency under the Board's report, as provided by rule 50 of the Board's Rules of Practice. In **petitioner's recomputation,** the claim was made for the **first time** that the minimum royalty payments stipulated by the leases had in some instances exceeded the amount of the per ton royalty which would have been payable on actual production, and it was asked that the depletion

allowance be computed upon the basis of the actual payments made, instead of upon the number of tons extracted. Petitioner, at a hearing on the recomputation, tendered evidence in support of this claim. The Board rejected the evidence, and denied petitioner's motion for a rehearing in order to present this contention. The court below upheld this action.

The Board is authorized to prescribe rules of practice and procedure for the conduct of proceedings before it. . . . . . Rule 50 prescribes the procedure for computing the amount of the deficiency after the Board has heard and decided the issues raised and presented on the merits. In terms, it directs that the hearing on the computation which it authorizes is to be 'confined strictly to the consideration of the correct computation of the deficiency or overpayment resulting from the determination already made, and no argument will be heard upon or consideration given to * * * any new issues.' The Board has held that under the rule new issues may not be raised and urged on a hearing upon the computation." (Emphasis supplied.)

In **Commissioner of Internal Revenue v. Erie Forge Co., 167 F. 2d 71 (3rd Cir.)**, the Court held:

"The **rules** prescribed are **merely procedural** and **cannot** under any circumstances limit or **control** the **statutory jurisdiction conferred upon the Tax Court.** (Citing cases.)

. . . . .

Morrisdale Coal Co. v. Commissioner, 3 Cir., 1938, 97 F. 2d 272, at page 288, held that **a new issue not included in the original proceedings could not be introduced for the first time at a computation proceeding; that it was not a matter of discretion** of the Board but was

forbidden by law. See Commissioner v. Sussman, 2 Cir., 1939, 102 F. 2d 919, a case apposite to the case under review. There the court sustained the Board's refusal to permit the Commissioner to amend to include an issue not present in the deficiency notice, notwithstanding that if the matter were being considered de novo the item sought to be raised would be most pertinent.

. . . . .

"The provisions of Rule 50, which precludes consideration of any new issues at that stage of the proceedings, represent a proper exercise of the power of The Tax Court to regulate practice before it." (Citing cases.) (Matter in parenthesis and emphasis supplied.)

In **Baldwin v. Commissioner, 94 F. 2d 355,** the Court held:

"The Board of Tax Appeals is specifically authorized to prescribe rules for the conduct of proceedings before it. Section 907(a) of the Revenue Act of 1924, as amended by section 601 of the Revenue Act of 1928, 26 U.S.C.A. § 611. Such rules have the force and effect of law. Bankers' Pocahontas Coal Co. v. Burnett, 287 U.S. 308, 53 S. Ct. 150, 77 L. Ed. 325; Goldsmith v. Board of Tax Appeals, 270 U.S. 117, 46 S. Ct. 215, 70 L. Ed. 494. **The rules** prescribed **are merely procedural** and **cannot** under any circumstances limit or **control** the **statutory jurisdiction** conferred upon the Board." (Emphasis supplied.)

In **Quintana Petroleum Co. v. Commissioner, 143 F. 2d 588 (5th Cir.),** the Court held:

"After the opinion of the Board of Tax Appeals was promulgated, the taxpayer for the first time, by alternate computation, contended

> that if the allocable bonus payments or advance royalties in the sum of $915.42 were excluded from gross income from production for purposes of percentage depletion, then said payments should be deducted from gross income generally in computing the taxable income. Rule 50 of the Board of Tax Appeals, 26 U.S.C.A. Int. Rev. Code following section 5011, directs that the hearing on the computation it authorizes shall be 'confined strictly to the consideration of the correct computation of the deficiency or overpayment resulting from the report already made, and no argument will be heard upon or consideration given to * * * any new issues.' In Bankers Pocahontas Coal Co. v. Burnet, 287 U.S. 308, 313, 53 S. Ct. 150, 151, 77 L. Ed. 325, the Supreme Court in referring to this rule said:
>
> " 'The Board has held that under the rule new issues may not be raised and urged on a hearing upon the computation.' "

Since The Tax Court made no determination or ruling that the taxpayers had erroneously paid taxes on sales, it could not, in the proceeding under Rule 50, undertake to compute the amount of such erroneous tax payment.

For the reasons set forth herein, the failure of the taxpayers to oppose the computation submitted by the Commissioner under Rule 50, does not, and cannot, bar plaintiffs' right to recover the admitted overpayments on the theory of res judicata or collateral estoppel.

The decision of The Tax Court in these very cases, conclusively dissipates defendant's conten-

tion that these actions are barred on the theory that the issues could have been litigated in the proceedings in The Tax Court under Rule 50.

In The Tax Court proceedings, an issue was raised as to whether Rose Schnitzer, the wife of Sam Schnitzer, and Jennie Wolf, the wife of Harry Wolf were bona fide partners of the Alaska Junk Company partnership. The taxpayers, in those proceedings, claimed that the Commissioner was barred from making that contention. This contention was predicated on the fact that in a prior Tax Court proceeding, the two wives were recognized and treated as partners **in making the computations under Rule 50** in the prior Tax Court proceedings. In those cases, it was the taxpayer who claimed the application of the doctrine of res judicata or collateral estoppel by reason of the proceeding under Rule 50, while in the cases at bar, the Government takes that position.

The Tax Court held (printed Transcript of Record, Joint Exhibit No. 1, page 54):

> "Petitioners contend that the wives' status as recognizable partners is res judicata and may not now be challenged. They cite this Court's opinion in their prior proceeding involving partnership income for 1941, and argue that the decision in their favor is conclusive of the issue here raised. Admitting, as they must, that the only error assigned related to the reasonableness of salaries, which the Commissioner had disallowed as a deduction in the computation of partnership profits for 1941, they insist that the Court's finding of an ex-

isting partnership comprising of wives 'was not merely collateral or incidental, but was material,' because the decision reached could not have been rendered without deciding that particular matter, and such matter was hence 'properly within the issue controverted.' Packet Co. v. Sickles, 5 Wall. 580; Southern Pacific Railroad Co. v. United States, 168 U.S. 1.

"We are unable to accept this view. In the prior proceeding the wives' status as partners was admitted by respondent, not controverted. And while the prior finding, based on the admission, in res judicata as to the parties' tax liability for 1941, Cromwell v. County of Sac. 94 U.S. 351, the present proceeding, involving tax liability for subsequent years, is based upon a different cause or demand. Under such circumstances, the Supreme Court held in Commissioner v. Sunnen, 333 U.S. 591, that:

" ' . . . . . the prior judgment acts as a collateral estoppel only as to those matters in the second proceeding which were actually presented and determined in the first suit. . . . .

. . . . .

" ' . . . . . If the legal matters determined in the earlier case differ from those raised in the second case, collateral estoppel has no bearing on the situation See Travelers Ins. Co. v. Commissioner, 161 F. 2d 93. . . . . .'

"Since the wives' status as partners was not placed in issue in the prior proceeding, it was not judicially determined. This is no less true because the uncontested finding was reflected in a computation of tax deficiencies under the decision rendered. Pelham Hall Co. v. Hassett, 147 Fed. (2d) 63; Harvey Coal Corp. v. United States, 92 Ct. Cl. 186; 35 Fed. Supp. 756; C. D. Johnson Lumber Corporation, 12 T.C.—(promulgated March 17, 1949. Ac-

> cordingly, we hold that recognition of the wives as partners in this proceeding is **not res judicata, and the doctrine of collateral estoppel does not preclude a determination of that issue on its merits now.**" (Emphasis supplied.)

In those cases, the Government maintained, and the Court held, that the proceedings under Rule 50 did not constitute res judicata or collateral estoppel.

Re: Cases Cited by Appellant

The case of **United States v. Sunnen,** supra, is not relevant to the question of the application of the doctrine of res judicata or collateral estoppel to cases that come within the exception to **Section 322(c).**

The impact of the rules of res judicata and collateral estoppel on the exceptions to **Section 322(c),** was not raised, discussed, referred to, or passed upon by the Court.

The case of **United States v. Clark, Inc., 159 F. 2d 489,** is not at all in point. In that case, **there was no prior Tax Court proceeding.** The taxpayer asserted a claim for refund. It was rejected and he brought an action for refund. The District Court denied recovery and the decision was affirmed by the Court of Appeal. The taxpayer then filed a **second claim for refund** for the **same amount** asserting different grounds and the Court, by a 2 to 1 decision, held that the first judgment was res judicata.

In the case at bar, there was no prior determination of their rights to a refund. The question was never litigated and could not be litigated until after the Tax Court decision became final and an amount admittedly in "excess" of the true tax liability was collected.

The case of **United States ex rel. Girard Trust Co. v. Helvering, 301 U.S. 540, 57 S. Ct. 855,** does not have the remotest connection with the questions involved. In that case, the Commissioner determined deficiencies in tax. The taxpayer appealed to the Board of Tax Appeals which determined that there was no deficiency in tax and also determined that there had, in fact, been a large "overpayment." The taxpayer instead of bringing an action for refund, sought a writ of mandamus to compel the Commissioner to pay the amounts of the overpayment determined by the Board of Tax Appeals. **The sole question before the Supreme Court was whether the mandamus was the proper remedy.** The Court held that mandamus would not lie and that the remedy was by a "plenary" suit for refund. The case is authority for appellees insofar as the Tax Court held it has no jurisdiction to order or adjudge a "refund" even where it finds that an "overpayment" has already been made. It can only make a determination that there was an overpayment. The Court held that if the Commissioner refuses to refund the overpayment so determined, the remedy is

> "by plenary suit . . . . . in the District Court or the Court of Claims."

The case did not involve the question of the application of Section 322(c) or the exceptions to that section, or the doctrine of res judicata, or collateral estoppel.

The case of **American Woolen Co. v. United States, 21 F. Supp. 125,** Court of Claims; also reported in **18 F. Supp. 783,** cited by defendants, is irrelevant. The case did not involve the application of any exception to Section 322(c) and did not involved any "excess" "collected" after the determination of the Tax Court became final. The issue in that case is crystalized in the syllabus No. 3 in the first decision (18 F. Supp 783), which is as follows:

> "Although taxpayer, having obtained favorable decision from Board of Tax Appeals (determining an overpayment) can bring suit thereon, taxpayer cannot recover amount of overpayment found by board, **where commissioner has applied overpayment in manner required by law, as by crediting it on a deficiency then due under board's decision.**" (Matter in parenthesis and emphasis supplied.)

This case is wholly unrelated to any question in the case at bar.

III

THE COURT BELOW CORRECTLY COMPUTED THE AMOUNT OF THE REFUND TO WHICH APPELLEES ARE ENTITLED.

The parties are in agreement that in making the computations of the amount of tax to be refunded, it was proper to deduct from "gross income" the amount of the "sales" which were held by the Tax Court to be "capital contributions." The Court gave judgment for refund on that basis.

Appellant contends that there should also be deducted from the "cost of sales," the cost of the merchandise which was delivered to Oregon Steel and held to be "capital contributions." The Court below rejected this contention.

Appellees submit that appellant's method of computation is erroneous because it ignores, and is contrary to, the basic principle that the net income, which is taxable, is not the profit realized in **each individual transaction,** but is the net income determined from the **operations for the entire year.** It is at the end of the year that economic gain or loss is determined based upon a computation of the entire year's experience.

In order to give effect to this basic principle inherent in the Income Tax Law, there must be deducted from the "gross sales," **all** of the money ex-

pended for the purchase of merchandise during the year and **not only a portion thereof.** All of the money expended in the purchase of merchandise during the year, must be deducted regardless of the manner in which the merchandise was disposed of. That is to say, all of the money expended for merchandise during the year, must be deducted regardless of the fact that the merchandise, or some of it, may have been sold at a profit or sold at a loss, or some of it became worthless through deterioration or other cause.

If some of the merchandise purchased was sold at a loss, or became worthless through deterioration, or other casualty, the cost of that particular portion of the merchandise must still be included in the **total** "cost of sales" for the year.

The taxable net income is not determined by the profit or loss sustained **in any given transaction.** The taxable net income is determined by the total of all "sales" during the taxable year and deducting therefrom the total of **all** cost of purchases during the taxable year, plus the statutory deductions for operating costs, etc.

All of the sales for the full taxable year must be included in the gross income whether the "sales" or any of them were made at a profit or a loss and, on the other hand, all of the costs of the purchases for the whole taxable year, must be reflected whether the goods were sold at profit, at loss, at

cost, or damaged, or destroyed, or otherwise rendered unsalable.

Appellant's theory would reverse this basic principle of the Income Tax Laws because **it would require the isolation of each sale transaction and allocate to it the profit or loss sustained in connection with the particular transaction** and by so doing, there would be created **a fictitious profit** upon which income taxes would have to be paid because to the extent that the cost of "sales" are reduced, the taxable net income is increased.

If a taxpayer purchases in a given tax year, merchandise at a cost of $100,000.00 (having no prior inventory), that is the amount of deduction that must be made from "gross sales" even though some of the merchandise may have become worthless and unsalable. The taxpayer is entitled to deduct the entire purchase price of $100,000.00 even though he derives no profit and, in fact, sustains a loss by reason of the loss of a part of the merchandise through deterioration and the like.

ILLUSTRATION

A taxpayer, having no inventory at the beginning of the year, purchases merchandise during the year at a cost of $100,000.00. He sells $90,000.00 worth of that merchandise during the year for $150,000.00 and $10,000.00 of that merchandise becomes valueless. What is the taxpayer's net income for the year? Obviously, the net income is

only $50,000.00 because he paid $100,000.00 for the merchandise during the tax year. If the cost of "sales" were to be reduced by $10,000.00, represented by the valueless merchandise, the taxpayer was compelled to report the cost of sales for the year at $90,000.00 (as appellant now contends), the result would be a net profit of $60,000.00, whereas the actual difference between all of the money spent for merchandise and the amount realized on the sale hereof, was only $50,000.00. Appellant's theory of the computation would make the taxpayer subject to taxation on an additional net income of $10,000.00, which he never realized. **The loss of his merchandise would then be converted into a taxable profit.**

We submit that this is an entirely unrealistic concept and is inconsistent with the general scheme of the Income Tax Law which taxes only economic gain ascertained and determined on an entire year's operations.

True net income can only be determined by charging against the "sales," the cost of all merchandise purchased and not only a portion thereof.

The situation in the case at bar is the same as in the illustration. The merchandise delivered by the Partnership to the Corporation was bought and paid for by the Partnership along with all of the merchandise purchased by the Partnership during the year in question. In reporting its "sales" for

the year, the Partnership properly deducted the cost of all merchandise purchased during the year.

The merchandise, which the Partnership delivered to the Corporation, turned out to be worthless just like the merchandise destroyed by deterioration in the illustration.

By no stretch of the imagination can the loss of that merchandise be converted into profit by the simple process of deducting the cost of that merchandise from the total of the purchase price of all merchandise bought during the tax year.

The adoption of appellant's computation would result in a fictitious profit. The loss would be converted into a taxable gain.

We submit that the computation adopted by the Court below was proper and should be affirmed.

Throughout the brief, appellant emphasizes the alleged fact that the "sales" to Oregon Steel were made at cost. We see no relevancy in that fact. All "sales" must be included in gross income, whether the "sales" were made at a profit, at cost or at a loss, and the "cost of sales" must, likewise, include all merchandise purchased whether disposed of at a profit, at cost, at a loss or rendered valueless. The total of each of the two columns determines the over-all profit or loss from the entire year's operations.

CONCLUSION

The outstanding fact in these cases is that there was collected from the appellees an amount in excess of their tax liability for the year. This is admitted by appellant.

The retention of the excess collected by the Government has been characterized by the Supreme Court as

> "immoral and amounts in law to a fraud on the taxpayer's rights." (Bull v. United States, 295 U.S. 247.)

Section 322(a) of the Internal Revenue Code is a remedial statute designed to avoid such consequences and should be liberally construed to effectuate its purpose of restoring to the taxpayer what was unjustly taken from him.

The limitations placed upon the collection of refunds in **Section 322(c)** and its exceptions, must be construed in the light of the remedial purpose of subsection (a) and the bar should not be applied unless there is a clear statutory mandate therefor. A statute which would deprive the taxpayer from recovering what is justly due him, must be strictly construed and if the statute is ambiguous or susceptible of more than one construction, it should be construed in favor of the taxpayer. The exceptions to **322(c)** were incorporated to protect the taxpayers from the operation of the bar under the conditions described therein and these exceptions

should be given effect. Exception No. 2 applies to the case at bar and should be given effect.

Appellant has not cited any authority in support of the computation contended for by the appellant. No reason in justice, equity or fairness is advanced in support of its contention. It is contrary to the basic principles applicable to the determination of taxable net income and should be rejected here as it was in the Court below.

The judgments, appealed from, should be affirmed.

Respectfully submitted,

S. J. BISCHOFF,
Attorney for Appellees.

Jacob, Jones & Brown,
of Counsel for Appellees.